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THE FOURTH QUARTER - A HARD LOOK

WITH the fourth quarter of the year just around the corner, observers of the economic scene lean overwhelmingly toward one view: the rest of the year will set new highs in industrial activity. The First National City Bank summed up the picture the other day: "Prices and incomes are rising, and in general optimism is more pronounced." As a natural consequence, few look for anything but continued tightness in the market for mortgages and other fixed income obligations.

Unanimity of this kind is impressive. On the other hand, if the past be any guide, major changes in business and financial trends invariably seem to begin when everyone is looking the other way; the cycle has little respect for Gallup Polls. Before lining up with the vast majority, in short, it may be worth while to take a good, hard look at the prospects for the next 3 months.

On the surface, U. S. prosperity has never seemed more glittering. National output of goods and services in the June quarter rose to a new peak annual rate of $408 billion, up $21 billion from the comparable 1955 period, the Department of Commerce revealed not long ago. As of mid-August, a record 67 million people were gainfully employed at the highest weekly wages in history. The operating rate in the steel industry lately has topped 100% of capacity, and excitement over the 1957 model cars, soon to be unveiled, is mounting. Prices of a great many raw materials and finished goods have been marked up.

Such facts and figures undoubtedly command respect. However, they should not serve to obscure several other key barometers which are giving less favorable readings. For example, in spite of the sharp recovery in steel operations, freight carloadings in recent weeks consistently have lagged behind last year's levels. Retail trade - particularly when adjusted for price increases - has shown little gain over 1955. Meanwhile, business inventories continue their unbroken and ominous rise. In the past 12 months, stocks held by retailers, wholesalers and manufacturers have jumped from $80 billion to $86 billion. Since the fall of 1954, when the current wave of stocking up first began, inventories have risen nearly $10 billion. A substantial chunk of current production, it thus would appear, instead of passing into the hands of the consumer, is winding up on shelves and in warehouses.

The actual business scene at the present time, in short, is decidedly more mixed than business sentiment. The same may well hold true of October-December. If the current inventory upswing should come to an end - and it already has lasted longer than most of its historical predecessors - the highly publicized fourth quarter upturn might either be weakened or offset completely. Whether in fact this will happen, of course, nobody can predict. But the possibility, far from being universally ignored, at least should enter into forward calculations.

Mortgage lenders in particular might do well to take it into account. For any change in business conditions (or, for that matter, merely in business expectations) could have a decided impact on the money market. Right now, as everyone surely must know, credit is tighter than it has been in a generation. The Federal Reserve Banks' rediscount rate stands at 3%; the commercial banks' charge to their best borrowers is up to 4%; quotations of Government bonds, notably the medium and longer-terms, have sunk to new lows.

This stringency naturally has been reflected in the mortgage market. As one indicator, the Federal Home Loan Banks, which were able to raise money at 3% in mid-1955, are paying 3.80% on their latest issue of 6-month notes. The Federal National Mortgage Association has never been busier. In the week ended August 31, some $21 million of home loans were offered to FNMA, a new peak, and the agency approved a record $13 million for purchase.

Similarly, discounts on FHA and VA mortgages have widened sharply. Early this month, a well-known New York City mortgage firm offered $4\frac{1}{2}\%$ VA loans on homes in Sacramento, California, maturing in 25-30 years, and with equities ranging from 5% to over 20%, at a price of 95. At this figure the yield to the lender (minus the customary $\frac{1}{2}$ of 1% service fee to the originator) would run to 4.62%. In some cities - notably Cleveland - no down payment VA $4\frac{1}{2}$s are quoted as low as 93.

Again, since last month FNMA has issued advance 1-year commitments on FHA and VA liens at a uniform price of 92. Besides this heavy discount, the seller must make a non-refundable cash payment of 1% to the agency; for one-half of the latter, he receives the equivalent in FNMA common stock, currently quoted over-the-counter around 45. All this adds up to an effective price of only 91-1/4. Nonetheless, FNMA reports that in its first week of operations under the new standby program, it bought 28 mortgages for some $300,000.

The tightness has shown up in still another way: a marked shift from Government-insured and guaranteed mortgages to higher-yielding conventional loans. In June, for example, FHA home loans amounted to only 8.6% of total recordings of $20,000 or less, compared to 10.2% in June 1955 (and 10.8% for all of last year). By the same token, VA home loans in June slipped to 17.4% of total recordings, from 21% in June a year ago (and 25% for 1955 as a whole).

Meanwhile, conventional home loans have risen to 74% of the total from 68% a year ago, the highest figure in nearly 2 years.

The switch has been particularly marked for some of the bigger lenders, notably the savings and loan associations. VA mortgages made by these thrift institutions in July represented only 10% of their total lending, against nearly 15% 12 months before, the smallest volume since July of 1954.

The sharp rise in the price of money simply reflects the fact that demand for this commodity of late has tended to outrun its supply. For example, in the first 8 months of 1956 States and municipalities tapped the money market for $3.7 billion, roughly 4% more than in the like year-ago period. Similarly, new corporate securities offered for cash in the first 6 months of this year ran to $5.2 billion, $300 million more than the corresponding months of 1955. In the June quarter alone, such offerings totaled $3 billion, a sharp advance from the $2.4 billion of last year.

However, undoubtedly the most striking upsurge has taken place in borrowings from banks. Since the turn of the year, commercial, industrial and agricultural loans of the weekly reporting Federal Reserve member banks have spurted from $26.2 billion to nearly $29.5 billion, an unprecedented advance. So great, indeed, has been the corporate demand for credit that some of the larger banks, to the dismay of the regulatory authorities, lately have been making what are, in effect, long-term capital loans.

Demand for credit, to be sure, has been less exuberant in some sectors. Thus in January-June, auto installment credit rose by only $896 million, vs. $2.6 billion a year ago. The volume of mortgage lending, too, owing in part at least to the drop in new housing starts, has tended to lag. In the first 6 months of 1956, according to the Federal Home Loan Bank Board, nonfarm mortgage recordings of $20,000 or less totaled $13,501 million, off 3% from the $13,912 million of the comparable year-ago period. Nonetheless, from all the foregoing, it is evident that on the whole, demand for funds thus far this year has been exceedingly - and unexpectedly - heavy.

What about the rest of 1956? On that score, most lenders probably would agree with W. A. Clarke, Philadelphia mortgage banker and former head of M. B. A., who recently remarked: "As long as business continues at a high level, I see nothing in the foreseeable future to make mortgage money any easier." On the other hand, though this year's painful experience has made them highly cautious, a few close followers of money market trends feel that a turn may be near. One newly organized firm, which hopes to interest pension funds in home loans, reports a growing interest among prospective clients who, a few weeks ago, refused even to nibble.

Just last week, Aubrey G. Lanston & Co., Inc., well-regarded specialists in Treasury and municipal securities, wrote its clients: "Is this the time to

buy? We don't like to disappoint you by saying 'we don't know,' but that is the fact. However, we can tell you that a small number of astute observers believe that, if this isn't the time, we are close to it and the number who hold such a view is increasing a bit. For the first time in some while, the massive ranks of those who have been able to see only a one-direction movement - downward - are being broken.'

While still tentative, there are at least some grounds for this minority view. Municipal financing, though up for the year to date, has slackened lately, as borrowers, in hopes of more favorable terms, have postponed new offerings. In August, new tax-exempt issues dropped to less than $200 million, compared to $258 million in August 1955, the lowest monthly total since early 1952. At the same time, since the end of June, business loans in the portfolios of banks in 93 cities outside New York have risen only $150 million, less than half the advance scored in the comparable weeks of last year. In short, with the exception of long-term corporate borrowing, which remains as avid as ever, a few faint signs of slackening in what seemed to be an insatiable appetite for credit have begun to appear.

So much for demand. As to supply, the signs and portents also seem more favorable than generally has been recognized. To be sure, the policy of the Federal Reserve authorities continues to be one of restraint. Nonetheless, since July 1, when seasonal credit needs began to mount, the Fed has pumped considerably more reserves into the banking system than it did last year. Meanwhile, the volume of savings is on the rise. The Federal Home Loan Bank Board recently estimated that individuals added $7.1 billion to their holdings of U. S. savings bonds, life insurance and savings accounts in the first half of 1956, nearly 1 billion dollars more than in the previous 6 months and $300 million (or 5%) above the first half of 1955.

In sum, the forces now at work in the money market seem destined, sooner or later, to lead to some easing of rates and terms. If business activity should prove less robust in the fourth quarter than has been widely predicted, the change might well occur by the end of the year. Swings of the pendulum, no matter how interminable they may seem on occasion, rarely last forever.